



How Should China Sets It's Monetary Policy

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Abstract

China's monetary policy has evolved from obscurity into spotlight due to its torrid economic expansion in recent times, as well as its exchange rate regime that has been under constant scrutiny of its trading partners. While China's economy is centrally-planned, it is veering more towards a market-based system with goals of stability and growth. With this in mind, this paper is an introspection of China's monetary policy since the establishment of the People's Bank of China (PBC) to the present. Additionally, this paper surveys empirical literature on the effectiveness of policy tools undertaken by the PBC. Recommendations are made to Chinese monetary authority on how to navigate the turbulent waves of economic fluctuations with a managed exchange rate, within its borders and beyond.

The Four Phases of Monetary Development in Modern China:

1. Phase 1: 1948 – 1984

People's Bank of China (PBC) was established on December 1, 1948.

Dual function as a central bank and the only commercial bank in the country.

Main responsibility was to be the accounting agent for the government by acting as an intermediary between the Ministry of Finance, which collected taxes, and the State Planning Commission, which allocated spending of those tax revenues collected.

2. Phase 2: 1984 – 1993

The second period of development started in 1984, when a series of bank reforms were implemented.

These reforms aimed to decentralize the monopolistic banking system at the time, so as to enable the banking system to become more competitive and profit-oriented.

3. Phase 3: 1993 – 1998

In 1993, the Chinese Communist Party Central Committee proclaimed for the first time that the **ultimate target** of monetary policy was to maintain **currency stability** through the management of the country's money supply

The central bank was bestowed the authority to make and implement monetary policy. Its main roles were to support economic growth and maintain the value of currency.

4. Phase 4: 1998 – Present

In 1998, a major restructuring with the PBC abolished all provincial and local branches, and instead the central bank opened nine regional branches.

Modeled after the Federal Reserve System.

Additionally, the State Council proclaimed its policy to maintain the stability of its exchange rate in order to promote economic growth in 1998.

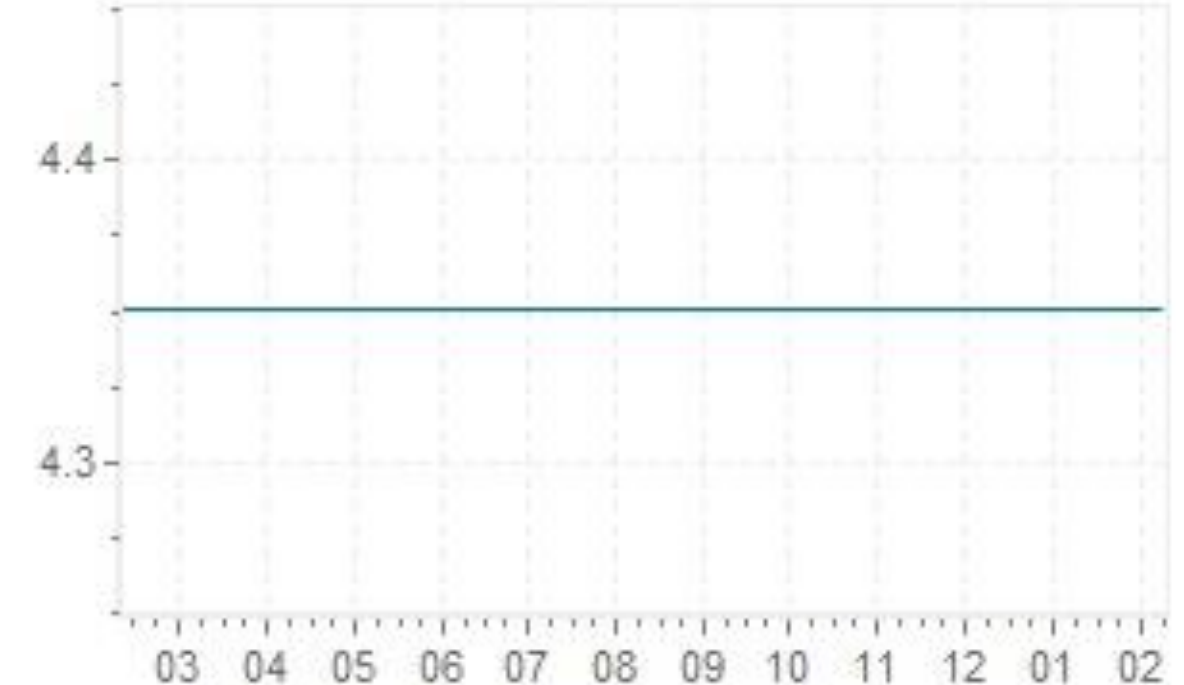
Together with this major restructuring is a need for money markets, therefore the beginning of market-based money markets.

Motivation of Paper:

- There is a dearth of literature on the modern monetary history of China.
- This paper is the first to trace the origin of China's foray into modern monetary policy.
- I chronicled the development of monetary policy in China since the PBC was established in 1948.
- I proposed a set of recommendations for China's monetary authority to consider.



Chinese interest rate PBC - interest rates last year



Chinese interest rate PBC - long-term graph



FINDINGS

- In order for monetary policy to be more effective as a tool to manage its economy, the Chinese central bank should loosen its control on interest rates and exchange rates so as to let borrowing costs better reflect their market conditions.
- In the long run, its monetary policy should consider following Taylor Rule to adjust its nominal interest rate instead of having an unstable, discretionary monetary policy .

References

- <https://www.federalreserve.gov/>